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The EU-25 *Fiscal Compact*: Differentiated *spillover* effects under crisis conditions

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ABSTRACT

This article analyses the intergovernmental Fiscal Compact, which represents the latest layer in the emerging new governance framework EU governments have adopted in response to the sovereign debt crisis in the eurozone. The crisis has initiated a new wave of selective functionalist spillover towards noticeably different levels of policy coordination between the eurozone-18 core and the remaining EU member states, who are divided into a semi-periphery and an outer periphery group. As an intergovernmental contract with currently 25 EU member states the Fiscal Compact signifies the decline of the traditional Community method of universal supranational integration in favour of a more differentiated form of intergovernmental policy coordination between groups of member states.

***KEYWORDS*: Differentiated integration, eurozone crisis, neofunctionalism, Fiscal Compact**

The 2008-09 global financial crisis severely affected the economies of the eurozone, particularly those of Southern Europe. The collapse of major US financial institutions such as Freddie Mac, Fannie Mae and Lehman Brothers had profound ripple effects on the economies of Ireland and Greece who suffered sudden drastic liquidity problems in the course of 2009. The same year markets became increasingly shaky about the stability of other eurozone economies, which raised questions about the long-term stability of the single currency. In March 2010 the European Union lead by an initially reluctant Germany responded with the initiation of the new annual cycle of policy coordination under the post-Lisbon *Europe 2020 Strategy.* This was followed by a *Euro Plus Pact* in spring 2011, which established enhanced policy coordination between the eurozone and six outsiders. At the EU summit in Brussels in December 2011 German Chancellor Angela Merkel and French president Nicholas Sarkozy went one step further and suggested a new treaty which would require member states to determine a fiscal spending brake in their national constitutions. This plan was rejected by the British prime minister David Cameron who argued that 'what is on offer isn't in Britain's interests' on the basis that he could not accept a 'treaty within a treaty' which would ultimately affect Britain's sovereign economic policy-making (Traynor, Watt, Gow and

Wintour 2012). Cameron had made his agreement on the inclusion of the treaty in the EU's *acquis* dependent on the inclusion of a protocol in which would guarantee Britain safeguards against an expansion of EU regulatory powers over Britain's financial services sector(Grant 2011).
The British veto against the Franco-German desire to instil budgetary stability in the EU treaty structure represents a significant development for the future of the EU. In effect it decouples Britain and currently also the Czech Republic from the emerging deepening policy coordination between the eurozone core and the outside periphery of non-euro members. The countries who signed up to the *Euro Plus Pact* (Bulgaria, Denmark, Latvia Lithuania, Poland and Romania) therefore emerged as the new *semi-periphery* which is closely associated to the deepening policy coordination in the eurozone-18 core. Latvia has in the meantime left the EPP and become a full member of the eurozone. The *semi-periphery* includes Hungary and Sweden, who are both not part of the EPP but nevertheless signatories of the March 2012 intergovernmental *Treaty on Stability, Coordination and Governance* (*'Fiscal Compact'*) which came into effect on 1 January 2013. Britain and the Czech Republic, who both opted out from the EPP and the *Fiscal Compact* currently represent the outer fringe of the EU's periphery.

The institutional failures of EMU

The divisions which emerged amongst EU member states with regard to the participation in the different layers of policy coordination illustrate the limitations of the classic Community method of integration. This has been evident for some time, most noticeably in the fact that Economic and Monetary Union (EMU) in 2002 had created a group of countries who voluntarily agreed to transfer the control over their monetary policy to the newly established supranational European Central Bank. The group of eurozone countries hence had moved further than those on the outside whose pooling of national sovereignty remained limited to the areas of binding Single Market legislation and limited areas of judicial and police cooperation. The emerging eurozone had clearly become the core project of the EU. It was widely expected that policy coordination would be extended to further areas such as employment policy, education, welfare and taxation and could even result in at least partial harmonisation in these areas (Hantrais 2007, p. 26). In reality the member states of the eurozone remained reluctant to accompany monetary union with deeper economic policy integration beyond the liberalisation agenda of the internal market. What was branded as a project which would combine monetary integration with the gradual binding coordination of core economic policy areas essentially ended up as a currency union with a set of budgetary rules which were after all interpreted in an extremely flexible manner. The original design of EMU consequently suffered from the fundamental flaw of taking away control over monetary policy from member states whilst practically failing to exercise an effective supervision of budgetary spending and a binding coordination of crucial policy areas such as wages, taxes and welfare (McCann 2010: 36). The adoption of the *open method of coordination* under the Lisbon Strategy in 2000 and its revised version in 2005 determined a set of targets which member states were expected to meet by engaging in a system of mutual policy learning under the OMC. The strategy essentially relied on the willingness of national governments to engage in best-practice benchmarking on the basis of peer pressure through a system which limited sanctions to being named and shamed in progress reports. In practice this resulted in insufficient progress towards national policy coordination and most significantly in the persistence of stark differences in the overall performance of member states in the policy areas which were operated under the OMC (Hodson 2010: 173).

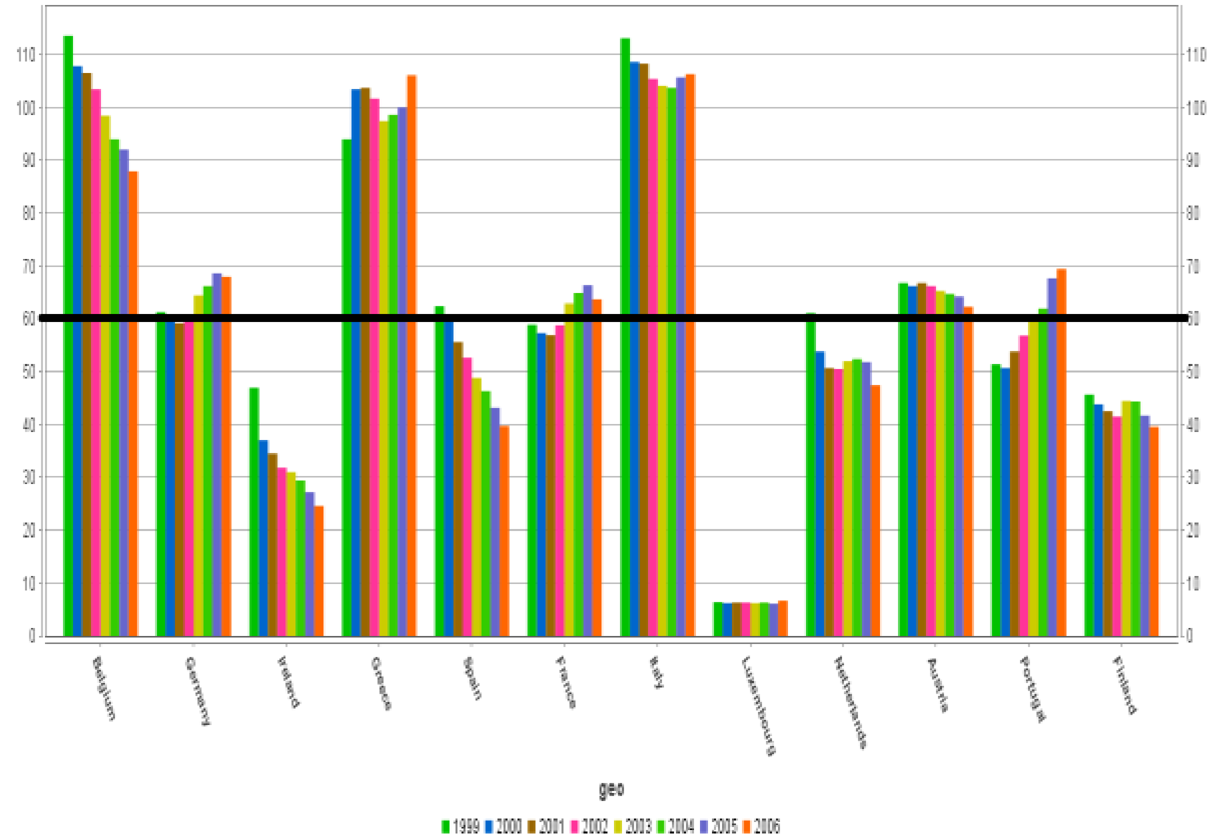
Philippe C. Schmitter has repeatedly argued that over time the *spillover* towards deeper integration did not emerge on the basis of internal pressures (such as demands by existing supranational actors to expand their powers) but in fact were caused by external factors: 'Much of what has happened since the mid-1970s can be better attributed to external trends and shocks than to purely internal processes and functional engrenages' (Schmitter 1996a: 13). Schmitter's interpretation of neofunctionalism also rejected the initial assumption made by Haas that *spillover* would ultimately take a linear progression of the transfer of powers from the national towards the supranational institutional level. Instead Schmitter spoke of the likelihood that the European integration process would progress erratically. In practice this would boil down to the direction of the integration process remaining multidirectional. Haas later followed Schmitter by adopting a more fine-tuned neofunctionalist approach in which he acknowledged that political actors in most cases fail to pursue a strategic long-term vision. Instead they would 'stumble from one set of decisions into the next as a result of not having been able to foresee many of the implications and consequences of the earlier decisions' (Haas 1970, p. 627). As a result, Community institutions and policies emerge incrementally and involve many twists and turns. From the perspective of Schmitter this included the possibility of the return of powers from the Community towards the national level ('spillback'). Most importantly for the analysis of the EU's current situation, Schmitter anticipated the likelihood that political elites would decide to adapt existing Community policies and institutions to new challenges ('encapsulate') rather than to follow a quasi automatic progression towards deeper integration (Schmitter 1970: 846). Schmitter also considered the post-Maastricht era to be much more likely to be characterised by a more flexible form of integration:

> 'For the MAT [Maastricht Treaty] opens the way for a multitude of relatively independent European arrangements with distinct statutes, functions, resources and memberships, not coordinated by a single central organization and operating under different decision rules' (Schmitter 1996b)

The creation of Economic and Monetary Union seemed to prove Haas's original neofunctionalist approach right. Under the budgetary limits set in the EMU *Stability and Growth Pact (SGP)* member states had initiated a process were the transfer of their national sovereignty in the area of monetary policy to the European Central Bank would be accompanied by an increasing intrusion of the EU into national fiscal policies (Börzel 2006, p. 224). The reality turned out be starkly different. In practice the SGP turned out to be a soft gentleman's agreement which was de facto operated under the same open method of cooperation as other policy areas such as employment, education and environmental policy under the Lisbon Strategy (Borrás and Jacobsson 2004, p. 193). Member state governments were consequently given substantial leeway in arguing against the execution of financial penalties under the excessive deficit procedure. This occurred most prominently when the European Commission dealt with the fact that France and Germany were unable to abide by the three per cent spending limit to annual borrowing and the 60 per cent limit to the structural deficit (both in relation to a country's annual GDP). In 2002 both countries started to breach the first criteria and continuously did so until 2005. By 2003 they also had started to exceed the 60 per cent limit of structural debt but nevertheless in both cases no proper excessive deficit procedure was initiated (Hay and Wincott 2012, p. 158). The background to this was that the European Commission under the leadership of former Italian prime minister and economics professor Romano Prodi adopted a very relaxed attitude towards the practical implementation of the SGP budgetary rules. Prodi himself had famously denounced the pact as 'stupid' and a straightjacket in an article in the *Le Monde* newspaper published on 17 October 2002 (Osborn 2002).

The widespread perception was therefore that the SGP failed to instil the fiscal rigidity it was supposed to deliver (Wyplosz, Nickell and Wolf 2006, p. 231). Instead budgetary laxity prevailed and those countries in the Southern periphery of the eurozone who entered the eurozone with existing structural deficit problems (such as Italy and Greece) made little efforts to rectify them. Rather than to be pushed towards fiscal consolidation by the supposed institutional constraints of the SGP, membership of the eurozone created a free rider syndrome. This manifested itself in additional layer of security for countries with budgetary imbalances who assumed that the eurozone countries would collectively come to their rescue if their fiscal position worsened rather than to risk the overall stability or even the collapse of the eurozone. Figure 1 illustrates this free rider problem as it shows that amongst the founding members of the eurozone Belgium, Greece, Italy and even Austria consistently maintained a level of gross debt which exceed 60 per cent of the national GDP between 1999 and 2006. From 2003 they were joined by France, Germany and Portugal. In the case of Belgium, Greece and Italy the levels of gross structural debt consistently ranged between 90 and 110 per cent of the national GDP. Italy never managed to lower the debt level below 100 per cent without facing any consequences under the excessive deficit procedure.

Figure 1: General government gross debt (% of GDP) in the Eurozone 12, 1999-2006



Source: EUROSTAT. Available at http://epp.eurostat.ec.europa.eu/tgm/graph.do?tab=graph&plugin=1&pcode=tsdde410&language=en&toolbox=data (accessed 27 February 2014).

The Fiscal Compact and the new phase of political *spillover*

On 2 March 2012 the 17 countries of the eurozone plus eight new member states signed the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* which has since been more informally referred to as the 'Fiscal Compact'. The German chancellor Angela Merkel had intended to incorporate the compact into the EU's existing treaty structure. The purpose of this was to establish it as a foundation for the stronger coordination of fiscal and macroeconomic policies in the eurozone but also to link the latter with those EU member states who have not adopted the euro. It was Merkel's and Sarkozy's joint aspiration that the constitutional embedment of a debt brake on the national level would be more acceptable to member states than moves to expand the powers of the Commission to influence domestic budgetary decision-making:

> In the face of the non-existing budgetary competence of the European Commission the inherent link of the debt rule with national law is best suited to make it compulsory for all of us ... I therefore believe that it is the biggest sanction to be condemned in your own country (Merkel and Sarkozy 2011).

British prime minister David Cameron was not convinced of this argument and moved to veto the incorporation of the treaty into the EU's *acquis* because of his refusal to agree towards the deepening of political integration beyond the eurozone core. The Fiscal Compact therefore ended up as an intergovernmental treaty between 25 of the member states, with the UK and the Czech Republic remaining on the outside. David Cameron tried to justified his veto against the Fiscal Compact to become a binding treaty for all EU member states by arguing that from his perspective the content of the treaty represents a decisive step towards the long-term goal of a European political federation, which he believes should be limited to the eurozone:

> Those of us outside the euro recognise that those in it are likely to need to make some big institutional changes. By the same token, the members of the eurozone should accept that we, and indeed all member states, will have changes that we need to safeguard our interests and strengthen democratic legitimacy (Cameron 2013).

Cameron's veto has to be considered in the context of the origins of the policy mechanisms which emerged in response to the eurozone sovereign debt crisis. It is obvious that these mechanisms are not part of a long-term visionary strategy for the future institutional shape of the EU. Instead they emerged on the basis of relatively ad hoc reactions to worsening economic circumstances in the eurozone and resulting adverse market reaction. This is illustrated by the German approach during the eurozone crisis, which was characterised by a hesitant and slow acceptance of the need to take a leading role in shaping a collective EU response to the crisis. In the initial stages of the emerging sovereign debt crisis in the eurozone Merkel did not share the view of British prime minister Gordon Brown and French president Sarkozy who both called for the EU to address the crisis collectively. Brown, who was struggling to bring a deepening banking crisis under control in the course of 2008, spearheaded calls for a collective EU strategy. Brown voiced his frustrations with the attitude of other EU leaders, most of all Merkel, who he considered to be in denial about the true scale of the emerging crisis:

> I sensed that most of Europe still considered the problem an essentially American one, even in spite of everything that was happening across Europe (...) I argued that European banks were more highly leveraged than banks in the US, and I argued that concerted European Union action was vital (Brown 2010 , pp. 52-53).

Sarkozy quickly moved to support Brown in this endeavour and started to publicly distance himself from Merkel's reluctance to consider EU for the ailing economies of Ireland and Greece in the form of recapitalisation or stimulus programmes. During the joint press conference with Merkel in November 2008, Sarkozy stunned the assembled journalists when he stated that France under his leadership was working on the crisis while Germany would remain in a deliberative position (Sarkozy and Merkel 2008). In the course of 2009 Merkel was forced to change her stance as the worsening economic and budgetary situation in Ireland and particularly in Greece risked threatening to undermine the future of the euro. As markets started to downgrade eurozone economies, beginning with the lowering of Greece's credit rating by the

Standard&Poor's rating agency in October 2009, the risk that the debt crisis would affect further eurozone countries became obvious. As a result Merkel started to warm towards collective European action which followed in a gradual process from the *Europe 2020* Strategy in 2010 towards the *Fiscal Compact* in 2012. This slow adaptation by Angela Merkel to the expectation that Germany was expected to take leadership was widely described as a 'reluctant hegemon' approach (Paterson 2011: 73). The Polish foreign minister Radek Sikorski aptly hinted at this when he reminded Merkel during his visit in Berlin in November 2011 that particularly Germany's partners in the Eastern part of the EU expected an active German role under the crisis conditions. In Sikorski's own words: 'I fear German power less than I am beginning to fear German inactivity. You have become Europe's indispensable nation' (Sikorski 2011: 9)

The Fiscal Compact which emerged from the ongoing negotiations on the reform of the eurozone Stability and Growth pact since 2010, illustrates that the EU has been affected by a new and unprecedented wave of functionalist *spillover* as a result of unprecedented and severe external circumstances. In this respect it has to be emphasised that the *spillover* which occurred since the onset of the sovereign debt crisis is different from previous waves in two ways. Firstly it is caused by external pressures which empowered non-governmental actors at the expense of governing elites. Secondly the spillover that occurred signifies a break with the classic Community method of integration which was orientated towards the goal of collectivising increasing policy areas.

I will address each of these characteristics individually. The first characteristic of the new wave of *spillover* is that its main driver was an exceptional external event in the form of the global financial crisis, which subsequently strengthened market forces at the expense of political decision-makers. This caused the, albeit reluctant, realisation amongst EU leaders that they had to rectify their initial failure to accompany monetary union with fiscal and economic policy coordination in order to regain market confidence and to re-establish at least a certain degree of political control over emerging events. This is in line with what revised neofunctionalist approaches considered to be one of the likely causes of integrative pressures towards political spillover, namely 'internationally induced incentives drive or reinforce the rationale for seeking supranational solutions' (Schmitter and Niemann 2009: 59). With the onset of the sovereign debt crisis in individual eurozone economies, bond markets and rating agencies started to become the key players in determining the prospects for economic recovery in the eurozone. Germany as the strongest economic and political player in the EU therefore reluctantly accepted the need to push towards binding policy coordination with the purpose of restoring market confidence and regaining political control in the eurozone. The crisis forced political leaders in the eurozone to abandon the informal consensus upon which they had operated the eurozone since its creation in 2002. This consensus rested on the assumption that the completion of monetary union with the transfer of monetary sovereignty to the European Central Bank would not require further steps towards binding policy coordination or even harmonisation. In practice this was reflected by the reform of the Stability and Growth Pact towards greater flexibility in 2005, only two years before the financial crisis harshly revealed the inefficiencies of the pact. Under the reforms the eurozone members allowed significantly more room for member states to put forward political reasons for breaking the budgetary limits and in essence therefore contributed towards a '(re)politicisation of fiscal relations' (Paudyn 2011: 2207). The *Fiscal Compact* represents a first significant step in moving away from the coordinative practical operation of the SGP and to introduce a system of binding budgetary supervision and fiscal responsibility. This was clearly Merkel's priority who rejected proposals to swiftly move towards further policy harmonisation in the eurozone. The prime example for this was Merkel's refusal to accept the introduction of Eurobonds which would naturally come with a more political role for the European Central Bank in independently supporting crisis economies (Hübner 2012: 174). Merkel considers the Fiscal Compact as a move towards restoring market confidence in the eurozone and ensuring the long term stability of the European Union by turning it into a 'stability union'. In her official declaration on the Fiscal Compact in the German parliament on 29 June 2012 Merkel emphasised that the purpose of the treaty was to learn the lessons from the failure to exercise efficient supervision and control over national budgets under the pre-crisis SGP:

> If the European sovereign debt crisis has shown us something than it is that the irresponsible fiscal policy of one euro country can endanger the financial stability of the whole eurozone. We have to put a halt to this (....) With the Fiscal Compact national governments and national parliaments connect themselves in an unprecedented fashion in order to transform Economic and Monetary Union into a stability union (Merkel 2012).

The fact that Merkel speaks of a 'stability union' rather than a federal union illustrates that she pursues a strategy of deepening intergovernmental policy coordination rather than to advocate the complete supranationalisation of further policy areas which would inevitably result in substantially enhanced independent regulatory powers for the EU institutional level. In spite of the British veto Merkel clearly has not abandoned her ambition to make the provisions of the *Fiscal Compact* binding for all 28 EU member states. Merkel emphasised in her address to the German *Bundestag* that this should happen 'whenever it becomes possible' (Ibid). This shows that she is adamant to ensure that budgetary stability is instilled not just in the eurozone but in the economies across the whole of the Single European Market. In terms of the future institutional shape of the EU and the eurozone Merkel however adopts a far more cautious approach and does not advocate the supranationalisation of further policy areas. Instead she promotes the deepening of binding intergovernmental policy coordination in further core economic policy areas. In an interview with the German weekly *DER SPIEGEL* which accompanied the ratification of the *Fiscal Compact* in the German parliament, Merkel laid out her rather pragmatic approach towards the future shape of the EU which she presented as a shared Franco-German vision:

> At this stage I do not see the necessity to transfer further competences to the Commission in Brussels. President François Hollande and I rather want a better coordination of policy areas which are crucial for our competitiveness. We are for example thinking of employment and pension policy but also taxation and social policy. Economic policy coordination in Europe is far too weak, it needs to be strengthened, which is different from giving more competences to the Commission (Merkel 2012, p. 30).

This shows that the political *spillover* that has occurred in the EU since the onset of the crisis leads to a more differentiated outcome in terms of both vertical and horizontal integration than previous developments, where binding supranationalisation for all member states was usually the desired outcome. The pressures exercised by financial markets on political actors have to this date resulted in only limited institutionalisation and creation of new supranational bodies such as the *European Stability Mechanism.* Instead member states governments have in effect continued to pursue a slight modification of a strategy which Schmitter characterised as 'encapsulation' in his early revision of Haas's original neofunctionalist approach. Schmitter defined this as a strategy by political elites 'to a respond to crisis by marginal modifications within the zone of indifference' (Schmitter 1970, p. 846). 'Encapsulation' is essentially the reluctance to radically alter the existing institutional setup in a given policy area beyond a certain integrative point. Schmitter considered this to be generally the default approach, especially in areas where 'actors adopt ever more divergent policies' and 'new initiatives in scope and level are likely to be very risky and contentious' (Ibid: 867). This approach was very obvious in the design of the eurozone before the crisis, where member states prioritised the protection of the competitive advantage of their domestic economies over the stability of the single currency, The resulting regulatory framework consequently favoured preserving national policy-making autonomy (Hall 2012: 357). Encapsulation was less visible in the horizontal dimension as even during the crisis period the eurozone has continued to enlarge to new member states. Between 2007 and 2014 the eurozone adopted six new member states (Slovenia, Cyprus, Malta, Slovakia, Estonia and most recently Latvia).

The essential question is to what extent the new policy mechanisms in the EU and the eurozone will remain within or alternatively move beyond a state of relative encapsulation, i.e. the pursuing a strategy of 'stable self-maintenance' (Schmitter 1970: 844), both in vertical and horizontal terms. The Fiscal Compact signifies a crucial development in this respect. At least to a certain extent the treaty shows the political willingness to move beyond encapsulation by deepening vertical policy coordination within the eurozone while at the same time attempting to maintain its horizontal openness towards the ten outsiders.

The Compact nevertheless also significantly reflects the current political reality within the EU, where even the external pressures under crisis conditions have not substantially weakened member state resistance against giving up their sovereignty in key policy areas. The treaty hence pursues the twofold ambition of combining 'ever-closer policy coordination in the euro area' with the promotion of 'conditions for stronger economic growth' in the EU as a whole (European Council 2012: 1). The overall purpose is to ensure the long-term stability of the eurozone by instilling fiscal responsibility amongst the participating member states. This is reflected by the fact that the 'balanced budget rule' in article 3 of the treaty of limiting the structural deficit to 0.5 per cent of the national GDP at market prices (Ibid: 11), which all signatories are expected to implement in their domestic constitutional legal framework, is practically only binding for the eurozone countries. Under the provisions of the treaty the latter are subjected to the new system of reverse qualified majority. The Commission is therefore permitted to initiate an excessive deficit procedure against any eurozone country who is considered to be in breach of the golden budget rule and the SGP limits without having to consult the Council first. The Council can only stop this process by a qualified majority. It is only eurozone countries who eventually face a potential financial penalty of a maximum of 0.1 per cent of the national GDP if the European Court of Justice agrees with the Commission that a case of non-compliance exists (Ibid, article 8, paragraph 2, p. 16). In spite of the strengthening of the Commission's independent supervisory powers under the provisions of the treaty, it also sets clear limitations and stops far short from equipping the Commission with executive competences beyond ensuring the compliance with the budgetary rules in the eurozone. The treaty emphasises that any corrective measures for member states deemed in breached of these rules by the Commission 'shall fully respect the prerogatives of national parliaments' (Ibid, article 3, paragraph 2, p.12). The

The treaty provides the legal basis for the intended compulsory supervision and coordination of national policies within the eurozone and also amongst the aspiring members on the outside. It remains vague on which policy areas should fall under this coordination other than to state that economic policy coordination should take place in 'all the areas which are essential to the proper functioning of the euro area in pursuit of the objectives of fostering competitiveness, promoting employment, contributing further to the sustainability of public finances and reinforcing financial stability' (Ibid, article 9, p. 17). The intention to improve the horizontal link between the eurozone core and the outside periphery is clearly visible in the fact that the treaty is deliberately open towards the inclusion of new signatories (Ibid, article 15, p. 23). Most importantly the treaty also guarantees all signatories who are currently not in the eurozone full participation in the euro summit meetings and the right to contribute to the institutional design of the eurozone (Ibid, article 12, p. 20).

Beyond the *Fiscal Compact*: Towards differentiated *encapsulation* or further *spillover*?

Until the plans for a eurozone banking union are put into concrete action, the Fiscal Compact remains the temporarily final step towards deeper policy coordination in response to the effects of the global financial crisis. In spite of the rather limited provisions of the treaty when it comes to constraining national policy autonomy, it has pushed two member states, who refused to subject themselves to its rules, into an outer periphery position. Both the British and Czech government opted out of the treaty due to concerns about of it potentially representing a first step towards the federalisation of the EU. Former Czech Prime Minister Petr Neĉas, who was under significant pressure from the Eurosceptic Czech president Václav Klaus not to sign the treaty in 2011, defended his decision to opt out by arguing that the treaty expanded policy cooperation beyond the desired focus on internal market liberalisation. Like David Cameron, Neĉas argued that his opt out represented the new reality of differentiated integration in the EU, where individual member states would want to choose in which policy areas they are willing to agree to deeper cooperation (Neĉas 2012). David Cameron spoke of the need to protect Britain from the vision of 'ever closer union' which the member states of the eurozone wanted to pursue and which was not the same flexible agenda he would like to see being implemented in the EU: 'This vision of flexibility and co-operation is not the same as those who want to build an ever closer political union – but it is just as valid.' (Cameron 2013).

The treaty therefore represents a crucial cornerstone for the EU whose leaders are currently unsure about which direction its future development should take. The Fiscal Compact reflects a definite chance towards differentiated integration between the eurozone core group and the periphery. The current division between a semi-periphery group of predominantly aspiring eurozone members and the relatively small outer periphery, which at present is represented only by the UK and the Czech Republic is likely to be only a temporary setup. Even if the eurozone core remains open towards horizontal expansion it is certain that not all countries who are at present on the outside will eventually want to join. More sceptical countries such as the Sweden, Denmark, the Czech Republic and most of all the United Kingdom are likely to reject eurozone entry on the basis that is would significantly constrain their national policy autonomy. The essential core-periphery division between the eurozone and the outsiders is therefore likely to remain in the future, even though existing member states will make attempts to avoid a horizontal encapsulation of the euro core. The level of horizontal encapsulation inside the eurozone will substantially depend on to what extent the new policy mechanisms are equipped to once again create the perception of what Schmitter has called 'equitable returns', i.e. beneficial outcomes from monetary integration in the form of boosting economic growth and supporting competitiveness. If the latter occur on the basis of the limited policy coordination adopted under the new mechanisms the willingness to move towards deeper policy coordination in further areas is likely to wane amongst eurozone. Renewed horizontal encapsulation of the new status quo or at best limited change by granting 'central decisionmakers with more resources or authority to redistribute returns' (Schmitter 1970: 858) is therefore a realistic prospect under conditions of medium-term recovery of the eurozone from the sovereign debt crisis. Support for a political federalisation of the eurozone remains limited, even amongst the central players France and Germany. Many other countries in the eurozone show an increasingly sceptical attitude towards what the perceive as a German attempt to narrow the purpose of the eurozone to that of a fiscal austerity union (Lane 2012, p. 64). This perception of the future of the EU being determined on the basis of German economic hegemony (Bulmer and Paterson 2013, p. 1388) is likely to be a substantial factor which will keep the EU on the path towards increasingly differentiated integration. Even in the current *Euro Plus Pact* group countries like Denmark and Hungary remain sceptical of the emerging policy framework (Schweiger 2013). For the foreseeable future the EU is therefore likely to waver between the option of encapsulation in a dichotomy between the eurozone core and the external periphery on the one hand and a more transparent differentiated integration between the now 28 membership base on the other hand. An increasingly differentiated encapsulation between multiple groupings of member states currently looks like the most likely and viable option to accommodate the increasing variety of national economic and political interests in the EU-28. The Fiscal Compact has created a flexible framework for the eurozone and rest of the EU to determine the right balance between encapsulation and further selective *spillover*.

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